OFFICE OF FEDERAL HOUSING ENTERPRISE OVERSIGHT
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Office of the Director

October 25, 2004

The Honorable Richard Baker
Chairman
Subcommittee on Capital Markets,
Insurance and Government Sponsored Enterprises
U. S. House of Representatives
341 Cannon House Office Building
Washington, DC 20515

Dear Chairman Baker:

As indicated in my September 9, 2004, response to your letter of July 23, 2004, provided below is a detailed response to your question regarding guarantee fees. As always, please do not hesitate to contact me with any questions.

Question 4

The adequacy of guarantee fees charged by Fannie Mae and Freddie Mac to cover expected costs and protect against risks associated with their guaranteed mortgage securities is an essential element of their risk management. Their average fee rates appear to be more than sufficient for that purpose and have contributed to their generally high returns on equity. Over the past 10 years, guarantee fee rates have far exceeded credit loss rates, as shown on the table below:

GUARANTEE FEE AND CREDIT LOSS RATES OF THE ENTERPRISES (in basis points)

Year	Guarantee Fee Rate		Credit Loss Rate	
	Fannie Mae	Freddie Mac	Fannie Mae	Freddie Mac
1994	22.5	24.4	6	8
1995	22.0	23.8	5	11
1996	22.4	23.4	5	10
1997	22.7	22.9	4	8
1998	20.2	21.4	3	4
1999	19.3	19.8	1	2
2000	19.5	23.6	1	1
2001	19.0	23.6	1	0.5
2002	19.1	22.0	1	1
2003	20.2	23.0	1	1

Freddie Mac's guarantee fee rates for the last four years are increased by roughly 3 to 4 basis points due to corrections made during the restatement period. The corrections primarily relate to the treatment of amounts often paid by Freddie Mac to mortgage loan sellers at the time of securitization in exchange for higher guarantee fee receipts during the lives of the loans. Rates in 2003 at both Enterprises benefited from interest rate declines, which caused faster amortization of up-front fees paid in the past to the Enterprises.

Adjusting for these considerations, rates have declined over the past decade, though by somewhat less than the decline in credit loss rates. Credit loss rates have benefited from exceptionally strong housing markets in recent years. However, guarantee fee rates are forward looking. A prudent level of guarantee fee rates must protect against expected future losses, not past losses. Over the past decade, the loss rate has averaged 3 basis points at Fannie Mae and 5 basis points at Freddie Mac. While underwriting and loss mitigation techniques have improved in recent years, their value has not been tested by difficult or even moderate market conditions. Accordingly, it is prudent to base guarantee fee pricing on an assumption of at least 3 to 5 basis points of credit loss..

Other, larger costs have to be factored in as well. In its recent financial statements Fannie Mae has estimated its administrative cost rate for guarantees at 5 basis points, accounting for about two-thirds of its total administrative costs, allocating the rest to its portfolio business. Freddie Mac last made such an estimate public for 2001. Reflecting Freddie Mac's somewhat higher cost structure, that estimate was roughly 6 basis points.

Another key component is the cost of equity capital. To meet their minimum capital requirements, the Enterprises must hold 45 basis points of capital per dollar of guarantees. This amount protects against the possibility that credit losses will exceed, perhaps by a very large margin, expected losses. Equity investors need to expect returns on their investments far in excess of yields on debt instruments in exchange for taking their greater risk of a large or total loss. If equity investors would minimally require an expected after tax return of 10 to 15 percent and the Enterprises' current yield on their investments using equity funds is about 5 percent before tax, the Enterprises need to incorporate about 5 to 8 basis points of expected profit into their guarantee fee rates..

One last marginal consideration is float income which can be an offset to costs. The Enterprises earn income on funds remitted by servicers before the Enterprises are required to pass them on to holders of mortgage securities. For Fannie Mae this can generally amount to 1 or 2 basis points. Freddie Mac's payment conventions are more complicated and result in much more varied results that are frequently lower, sometimes negative.

Adding the costs; 3 to 5 basis points for expected credit loss, 5 to 6 basis points for administrative expenses, 5 to 8 basis points for equity capital; and subtracting 0 to 2 basis points for float results in a guarantee fee of roughly 11 to 19 basis points. The wide range reflects the difficulty of measuring costs precisely, their sensitivity to product mix, and their dependence on subjective forecasts of interest rates, house prices, prepayment behavior, and other factors. The Enterprises are able to price at the high end of the range because their GSE status makes their guarantee more valuable to investors than those of other financial institutions and significantly inhibits competition in the secondary mortgage market for conforming loans. Thus, while the fees received prudently cover costs and provide essential risk protection, they also contribute to the Enterprises' unusually high rates of return.

We are also looking into differences in guarantee fees the Enterprises charge different loan sellers. OFHEO collects information on the single-family mortgages securitized by Fannie Mae and Freddie Mac. We have started to analyze that data to assess how fees vary across sellers. To the extent feasible, we will consider how much of that variation reflects differences in the risk characteristics (such as loan types, loan-to-value ratios, and borrower credit scores) of the mortgages delivered to the Enterprises by individual sellers. Such research is complex and time-consuming, and limitations of the data may preclude our reaching definitive conclusions. Nevertheless, we believe it is worth pursuing and expect to provide you with further analysis based on this work when it is available.

Sincerely,

Armando Falcon, Jr.
Director